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Local Government Revenue Strategies: Recognizing Pitfalls in the Intergovernmental Fiscal Reform Experiences of China and the Philippines

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<u>Local government revenue strategies:</u>
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In the ongoing discussion and debate over fiscal decentralization in Indonesia, there seems to be a dramatic chasm between two sides. One side believes that decentralization should occur as fully and as rapidly as possible and is the only acceptable option for the political and economic sustainability of the Indonesian Republic. The other believes that the entire idea of decentralization for Indonesia is fraught with peril akin to walking off the precipice of fiscal insolvency, economic instability and national fracture.

While the title of my paper refers to local government revenue *strategies*, it is actually my belief that fiscal decentralization is a stylized process that actually may not be amenable to considerable direction by a single government strategy. Instead, it is considerably arguable that decentralization is actually a process that largely unfolds discontinuously – initiated and pushed along by certain forces, and being resisted and restrained by others. Differing factions on each side of the decentralization debate many times will not even have the some motives in mind even if their general support for or opposition to decentralization overlaps. This is clearly the case in the Indonesian context, where the topic of fiscal decentralization has been traced back to a policy paper prepared by the Ministry of Home Affairs in the 1970s – which was not consistently followed through on, but the focus of which has continued to surface from time to time. The most recent decentralization effort has been initiated by the executive leadership of the national government of Indonesia with one major intention in mind – ensuring the stability and integrity of the republic. Yet, decentralization has also been pushed forward by various regional interests with particularly different motives in mind. On the other hand, certain executive ministries and regions also wish to restrain the decentralization effort for various reasons. Even international agencies – multilateral financial institutions, bilateral partnership efforts, and non-governmental organizations – have widely differing views on Indonesian fiscal decentralization. And, this is only the modern history of debate on the Republic's intergovernmental fiscal relations.

Because of this ongoing debate, and because fiscal decentralization can and must be adapted to suit the particular needs and fulfill the particular objectives of each society, to claim that there is one best strategy for Indonesian decentralization would be rather presumptuous. However, there are certainly concerns to keep in mind and there are tactics for avoiding certain pitfalls of decentralization and for approaching certain objectives of decentralization. It is my intention to review some of the pitfalls that have been experienced in two other countries' intergovernmental fiscal reform processes – those of China and the Philippines – so that as Indonesians continue their national dialogue on decentralization strategy they might have these lessons in mind to draw from.

<u>Why China and the Philippines?</u>

China and the Philippines both offer worthwhile case studies for Indonesia. Not only because both are unitary state systems with complex multi-tiered structures, similar to that of the Republic of Indonesia, but also because both have undergone major reforms of their intergovernmental fiscal systems in the fairly recent past – far enough back so that some more definitive lessons can be drawn from them, yet not so far back that the lessons might be considered outdated.

China is a particularly salient example for Indonesia because of its size as well as its similar intergovernmental structure. Large countries tend to decentralize their governments because of the diseconomies associated with large central government bureaucracies, wide variations in the demand for public services, and their considerable degree of cultural diversity. China, however, is the most populous country in the world, and yet maintains a highly centralized fiscal structure. As such, China presents the case of an 'outlier' or notable exception to the pattern of fiscal decentralization, much as Indonesia does as it finally approaches decentralization. The Chinese intergovernmental structure has the following characteristics that will also likely sound similar to current conditions in Indonesia or designs under consideration:

(1) All tax rates and tax bases are centrally determined;
(2) Each subnational government receives a designated share of revenue collections made within its boundaries; and
(3) Tax administration is a responsibility shared between central and local governments.

In terms of the structure of government administration, The four levels of local government below the central government are (1) **province**, comprising 27 provinces and 3 cities (Beijing, Tianjin and Shanghai – 9 other 'line-item' cities are also treated as provinces); (2) **prefect**, including 151 prefectures and 185 cities; (3) **county**, with 1,903 counties and 279 cities; and (4) **township**, with approximately 56,000 townships, towns and city districts.[1] While there are obvious differences between the two countries, because China is a country with a similar centralized intergovernmental structure, as well as the only country of comparable size that has recently reformed its fiscal system, it provides a unique model for intergovernmental fiscal reform in Indonesia.

The Philippines provides another valuable example as a country with a similar intergovernmental fiscal structure that has recently undergone intergovernmental fiscal reforms. It is a presidential republic with a bi-cameral legislature, whose central government is divided into 15 administrative regions and one autonomous region, the Autonomous Region of Muslim Mindanao (ARMM). The second tier of government is that of the subnational governments, composed of three layers: provinces, which are then subdivided into municipalities and cities, both of which are then subdivided into *barangays* (or neighborhoods). One important exception to this general framework is that highly urbanized cities hold the same status as the provinces, but are still divided directly into *barangays* as the taxonomy would indicate. There are 77 provinces, 72 cities, 1,548 municipalities and approximately 42,000 *barangays*.[2] Each sub-national government is largely autonomous – headed by elected executives and legislatures – although higher level governments exercise some degree of supervision over lower level governments in terms of budgeting and legislation. As such, the national-subnational structure of the Philippines presents considerable similarity to that of the Republic of Indonesia, and the 1991 fiscal reforms of this other Southeast Asian island country also hold the promise of considerable lessons for those to be undertaken by Indonesia.

CHINA: The problem of extra-budgetary financing

In my discussion of China, I will focus primarily on the problems it faced in terms of extra-budgetary financing by local governments, which in some cases manifested itself in the form of internal trade barriers, one of the particular concerns in Indonesia today and a particular issue of focus at this conference. However, it is my concern that the pursuit of domestic trade protection is but one symptom of broader spectrum of threats to the efficient, stable and transparent operation of domestic markets that can arise from improperly structured intergovernmental fiscal relations, as the case of China demonstrates. In the next section, I will turn to the Philippines and will proceed to give additional examples of intergovernmental fiscal conditions that might encourage sub-national governments to seek alternative strategies for financial self-determination.

Moving first to China. In reviewing the case of China, I will discuss two stages of intergovernmental fiscal reforms – one that was undertaken in 1988, and another that was taken in 1994. It is important to distinguish that these reforms in China were pursued not for the purpose of decentralization, but rather to improve overall fiscal policy in the country and in fact as attempts by the central government to regain greater control of the fiscal system. However, in spite of this intent, China's relative success in *re*-centralizing and correcting the deficiencies in its fiscal system has actually brought the nation to a point where it might now be better able to pursue a process of

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[1] Roy Bahl (1999) Fiscal Policy in China: Taxation and intergovernmental fiscal relations (San Francisco: The 1990 Institute)

[2] William Loehr and Rosario Manasan (February 1999) Fiscal Decentralization and Economic Efficiency: Measurement and Evaluation: CAER II Discussion Paper No.38 (Cambridge: Harvard Institute for International Development)

decentralization should it decided to do so. In this sense, Indonesia, looking to decentralize already, is in fact a step ahead of China.

The Chinese fiscal structure is dominated by taxes paid directly by businesses (i.e. a value-added tax, product tax, business tax, and enterprise income tax). By the early 1990s, these taxes accounted for about 80% of total tax revenue.

Unlike the more common top-down model of intergovernmental fiscal relations in which taxes are collected by the central government, a share is retained, and the remainder is then distributed to sub-national governments, the Chinese fiscal system prior to the 1994 reforms was a 'bottom-up' system in which local governments were responsible for collecting taxes and retaining their share, as agreed upon with the central government, and then 'sharing up' the remainder of the revenues. Nevertheless, while tax administration was the responsibility of sub-national governments, taxes were still controlled – rates and bases were still set – by the central government. It is obvious that in such a system local governments would have considerable incentive to divert 'excess' revenues from the official tax collections to avoid their being 'shared up' with the center.

Before 1988, this tax-sharing between the central and local governments was done by formula. However, by 1988, there was sufficient dissatisfaction with the formula system – both local and central governments felt that their shares were too low and that the formula was too arbitrary – that the system was reformed. In an effort both to encourage greater revenue mobilization and to decrease incentives for diverting taxes, the new structure provided for each sub-national government to be able to 'negotiate' with the central government both the basic level of taxes it would be able to retain as well as a greater 'share' it could retain of the taxes it collected beyond this base level.

However, in spite of this reform effort, there continued to exist considerable incentive to move revenues 'off-budget' to avoid revenue-sharing, and such diversionary practice continued to dominate than the incentives to increase 'on-budget' collections reported to and shared-up with the central government. An example was **Jiangsu Province**, whose **extrabudgetary revenues rose from 67% to 92% of budgetary revenues from 1985 to 1989**.[3] Moreover, by 1992, total **extrabudgetary revenues of all local governments were equal to 86% of budgetary revenues** and **557% of central government extrabudgetary revenues**.

The primary mechanisms for moving these revenues off-budget were 'tax contracting', user fees and charges, and local departmental assessments. Beginning around 1986, tax contracting became the accepted method of setting local income tax rates with enterprises, particularly state owned enterprises. Officially, tax contracting entailed local governments negotiating with businesses in their jurisdiction as to the amount of tax the enterprise would be liable for; unofficially, it provided local governments with the opportunity to offer businesses lower tax burdens for contributions to an 'off-budget' account of the enterprise, which it would then spend on public services as agreed to with the local government. Additionally, local governments would assess on enterprises user fees or charges, including internal trade assessments, which were earmarked for a specific purpose. Finally, local "departmental assessments" (in some circumstances in the form of local trade (import) taxes) were collected by local government offices and kept for their use rather than mixed with general revenues. Notably, an additional motive for internal trade tariffs was also to protect local industries in order to increase the potential of the tax base.

As such, these various forms of extrabudgetary financing hampered the central government's ability to collect revenue, conduct macroeconomic policy, and equalize provincial fiscal disparities. Moreover, it contributed generally to a lack of transparency in the intergovernmental fiscal system; a blurring of legal and illegal local government and business behavior; and a less level, competitive and efficient market. In this context, I hope that it is understandable why I stress that while internal trade disruption is a critical problem to be on guard against, it can also be simply a symptom of broader deficiencies in intergovernmental relations.

In order to understand the lessons to be learned from the Chinese experience, we must recognize what were the causes of extrabudgetary financing efforts of sub-national governments. Arguably, the primary causes of such undesirable behavior were the obvious lack of not only own-source revenues (locally controlled revenues collected and retained by local governments), which the 'back-door' (off-budget) tax collections provided, but also autonomous expenditure designation.

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[3] Bahl, p.91.

While Chinese sub-national governments did retain a share of the taxes they collected, tax rates and bases as well as expenditures were all assigned by the central government. Thus, these 'local' taxes weren't really under local control but were actually still centralized, and extrabudgetary financing was the only real possibility that sub-national governments had for matching local services with local preferences. As such, instead of being a cause of internal trade levies, as some persons in Indonesia fear to be the case, fiscal decentralization, which allows sub-national governments to match local services with local preferences, may actually be the best way to eliminate the incentives for this and other extrabudgetary financing efforts.

A related lesson to be learned from this is that true local fiscal autonomy depends not simply on the allocation of revenues to a local government but also on the ability of these governments to determine expenditures as well as to adjust taxes as appropriate to provide sufficient revenue to fund these expenditures. If revenues are provided but expenditure autonomy is not allowed, then extrabudgetary financing may be the option sought after by the local governments to secure such autonomy. Additionally, if revenues are provided at a certain level without the proper assignment of expenditure responsibilities, such shared revenues may be insufficient and still encourage off-budget revenue-seeking. Because of this it is important to keep in mind Professor Bahl's adage that 'finance follows function' – or that expenditure responsibilities should be assigned first so that revenue sources can then be matched accordingly. This is a particularly timely lesson to keep in mind now in Indonesia's decentralization process as expenditure responsibilities have not yet been determined, yet Law 25 calls for a 25% of central government revenues to be shared with sub-national governments and the DPR has already agreed to devolve 20% to sub-national governments; and *yet* there is still no government leadership on ensuring that sub-national governments also have own-source revenues. If not assigned correctly, these particular attempts at decentralization could still establish the wrong incentives for back-door local government financing efforts.

Finally, the case of extrabudgetary financing in China is a good model of Casanegra's adage that 'tax administration is tax policy', in that the design of the Chinese tax administration as a 'bottom-up' system created a situation in which local tax administrations had divided loyalties between central government dictates and local pressures, and in fact significantly determined the *true* form of China's tax policy and its favoring of local government tax evasion. The lesson to be learned here for Indonesia is that care must be taken not to go too far or not far enough in decentralization. The difficulty in China was that the implementation of a *centrally directed* tax system was assigned virtually exclusively to *sub-national* governments – a poor mix of mechanisms and incentives that encouraged the direction of the central government to be evaded by the sub-national administrators. While most considerations of Indonesia's tax reforms have contained the expectation that tax administration will be decentralized, some observers recommend that tax direction continue to be a central government responsibility. This would inadvisably mimic the dysfunctional arrangement of the pre-reform Chinese fiscal system, which could not be made to run more smoothly until the 1994 reforms divided China's tax system between two separate and more-or-less autonomous levels of administration – national and local. However, it is also important to note that the alternative is not necessarily to move immediately to two wholly autonomous systems in Indonesia, but rather simply to be deliberate in recognizing that a properly functional fiscal revenue and expenditure system in the republic must ensure that the incentives of its administrators are in line with the direction of the system.

PHILIPPINES

In the case of China, I looked specifically at the problem of extrabudgetary financing, which was associated in some cases with internal trade barriers. However, a key point to the discussion was also to point out that in avoiding such problems as extra-budgetary revenue-seeking and internal trade protection, we have to consider more broadly the incentives that encourage such actions and be aware of how to avoid these pitfalls. Now, I will turn to the Philippines experience and will focus more on some of the decisions in fiscal decentralization policy that might provide less desirable incentives for local government behavior.

The need for local government capacity-building: the example of tax-collection. One problem that the Philippines faced was the lack of efficient local tax collection. It was expected that local taxes would encompass an increasing proportion of Local Government Unit revenues in the Philippines. However, this has not been the case. During the eight years prior to the implementation of the Local Government Code (1983-91), local-source revenue of all LGUs in the aggregate was mildly inelastic, with a buoyancy (ratio of percentage change in revenue to percentage change in GNP) of 0.97 – indicating that local-source revenues did not keep pace with overall growth of the economy. This lack of buoyancy was mainly due to the inelasticity of the real property tax (RPT, or tax on land and business property), which accounts for more than 50% of total LGU tax revenues. The buoyancy of the RPT during the 1983-1991 period was only 0.88 – lower than all other components of LGU revenue.

Following implementation of the Local Government Code in 1991, the overall buoyancy of local source of all LGU revenue improved dramatically. However, whereas the improvement in non-RPT tax buoyancy was due primarily to improvements in rate changes, the improvements in the RPT were mostly due to a general revision of the schedule of assessed value of real property in 199-93 and 1996-97. Hence, the increased RPT buoyancy reflects assessed value increases, not an improvement in administration.

Moreover, in spite of this improvement following the real property revaluations, property tax revenue collection in the Philippines has represented a net loss for most Local Government Units. In particular, three findings are important to keep in mind[4]:

(1) Local Government Units fail to collect even one half of the total revenue due to them.
(2) Collection costs exceed collected revenues in all cases studied with only one exception[5].
(3) Even if 100 percent of taxes due were collected (in other words, a collection efficiency of 100% - more than double what it is in reality), and costs of collection were held steady in the range from 0.44 to 0.61 Peso, the RPT yield would only be between 1.64 and 2.27 Pesos.

In other words, even at its most efficient (in terms of both collection and cost efficiencies), the RPT would not be a significant revenue source – and even worse, in its current state the RPT is actually a burden. While collection efficiencies did generally improve following the Local Government Code's implementation, collection costs did not. As such, while the revenue collected through the RPT makes it seem as if it is an important source of revenue, because collection costs are greater than collected revenues LGUs actually lose money through the imposition of the RPT and would be financially better off without it.

However, if problems were solved, the RPT has the potential to be a significant revenue source. RPT revenue is determined by the tax rate, the collection rate (the ratio of actual tax revenue to tax liability), the assessment ratio (the ratio of assessed value to the RPT fair market value), and the assessment efficiency (the ratio of the fair market value to the true market value). Studies have shown that in the case of the Philippines, an improvement of the collection rate to 100% (from 50%), would increase revenue 100%. Doubling the tax rate would double the tax. Improving the assessment efficiency to 1 (from 0.33), would increase 200%. And improving both the collection rate and the assessment efficiency (fair market value to true market value) to 1, revenue would increase by 500%. In other words, correcting the undervaluation property have the greatest potential in increasing revenue; improving collection would also lead to substantial growth; and overall RPT tax capacity is certainly not negligible in spite of its current state.

However, without the local government capacity to correct these deficiencies in assessment and collection in a cost-effective manner, the Philippine local governments were basically left with little recourse for own-source revenues. While the studies do not identify the issue of local extrabudgetary financing in the Philippines as being a problem, this may be due to a host of reasons in terms of political structure, law enforcement, and so on. However, it is still the case that the lack of an effective own-source revenue can provide an incentive to alternative revenue-seeking efforts. With this in mind, it is important to recognize the example of local tax inefficiency in the Philippines should be considered as Indonesia does get under way with its consideration of allocating revenues

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[4] From GOLD project data collected in four provinces (Capiz, Cotobato, Nueva Vizcaya, and Palawan) and in several of the municipalities within these provinces.

[5] The exception was the province-wide average for Capiz.

among the various levels of government. The case of the property tax in the Philippines is particularly important as it also presents one of the more advisable own-sources of revenue for Indonesia's decentralization effort, particularly as the individual income tax has been estimated as been collectable in the 1/3 of the provinces with significant urbanization.

One proposal that has been put forth for Indonesia so that it might be able to avoid this problem of inefficient tax collection is to decentralize tax rate-setting while maintaining tax collection as a national service, at least in the early stages. Such a policy could also have additional benefits, as discussed above in avoiding the problem of local government administration as occurred in China, at least until local government capacity can be built up to a sufficient level.

<u>The need for true decentralization of fiscal administration</u>. Studies in the Philippines have also demonstrated that while expenditure assignments are 'generally clear and well understood' by local governments, the national government does not always allow these sub-national governments to carry out their expenditure responsibilities independently and continues to dictate their responsibilities to them. This interference in local government affairs comes from various sources, including:

(1) The Department of the Interior and Local Government (DILG) is responsible for 'supervision' of sub-national government expenditures; however, 'supervision is not adequately defined.
(2) DILG and other central government bodies and officials continue to view sub-national governments as dependent administrative units rather than independent local governments.
(3) As is common and acceptable practice, multilateral and nongovernmental institutions construct programs In discussions with international donor agencies, central government officials draft policy plans that impact local government

Moreover, there are some signs of creeping re-nationalization of devolved activities in the Philippines. While national government spending decreased from 11.65 of GNP to 11.4% from 1992 to 1994 (a surprisingly small drop during a major shift to decentralization), national government spending rose after 1994 to a level of 13.2% of GNP in 1997.

Once again, such re-nationalization of fiscal responsibilities is a matter to be aware of in Indonesia as well, particularly if it begins to impinge upon local government autonomy. Not only are the efficiency gains from more localized control of revenue and expenditure decisions lost, but if such re-nationalization decreases the autonomy of local governments, this may again present an incentive to look to alternative strategies of revenue collection and expenditure determination.

<u>The need for monitoring: examples of inefficiencies and expenditure-switching</u>. Finally, in the case of the Philippines, I want to switch for a second away from the question of extrabudgetary financing to what may be a graver concern of insufficient spending. As is to be expected in a decentralization process, LGU social expenditure rose markedly at all levels of local government after the implementation of the Local Government Code. Aggregate LGU expenditure rose from an average of 1.6% of GNP (1985-1991) to 3.3% after the Code (1993-1997). Obviously, much of this increase does not necessarily represent in increase in overall spending on local services, but is simply a transfer of expenditure responsibility from the central government to the LGUs. In order to assess whether LGUs in fact did increase, or decreased or shifted, local social expenditure, one has to consider the new level of LGU spending along with the devolved expenditure responsibilities.

As it turns out, actual aggregate LGU spending in 1993-1994 was in fact more than what was estimated as necessary to maintain local government expenditures at their 1991 levels (adjusted for inflation and population growth, in other words – in *real per-capita* terms). However, while the aggregate level of expenditure was more than sufficient to match estimated costs, it is notable that spending did not increase in all sectors and actually decreased in some. In particular, by 1994 spending of all LGUs on 'General Public Services' (mostly 'Public Administration') was nearly double what would have been necessary to maintain the pre-Local Government Code Levels and expenditure on 'Other' services was more than three times what was estimated as sufficient – a premium of nearly P12.0 billion (pesos), or more than one-fifth of total local government expenditure. It is striking that this P12.0 billon premium on expenditures not directly related to services is nearly equal to total expenditure (roughly P15.0 billion) on social services! In 1993, this premium on public administration and other services was not quite so drastic – nearly P5.0 billion (pesos) – but it was still more than one-tenth of total LGU expenditure, and nearly twice as much as the shortfall in spending on economic services (approximately P1.0 billion), health (approximately P0.5 billon) and social welfare, labor and other social services (approximately P0.8 billion).

While it is an expectation of fiscal decentralization that local governments will reassign spending priorities and is typically acknowledged as an efficiency gain, one must also be skeptical of such dramatic expenditure shifts to administration and away from basic social services. At best, it may be a sign of local government investment in administration; at worst, it may be a sign of inefficiency or fiscal mismanagement.

This behavior suggests that it is important for central governments not only to maintain adequate monitoring of local government expenditures, but also to consider setting standards or mandates to ensure basic levels of service provision. Another possibility is the provision of targeted grants. These may decrease local autonomy to some degree, but the minimal loss of autonomy may be justified. These recommendations should be particularly considered in the case of Indonesia, where concern about corruption (or KKN, korupsi, kolusi and neptismi) are already widespread.

It is my hope that this very quick review of some of the exigencies of the fiscal reform processes in China and the Philippines will help all of you to consider how to reform Indonesia's fiscal system as well. While I have touched on only a few examples and lessons to be learned from two countries' experiences, it is my belief that these experiences bear considerable value for Indonesia because of the similarities of these situations to the current state of Indonesia's fiscal system. Just as importantly, I hope that by providing some examples of how some policies that might look correct at first can actually be problematic, that I have helped to make you more aware of how you can trouble-shoot the various proposals being discussed for fiscal reform here. It is the ability for critical reflection more than anything else that will allow Indonesians to find the best solution to their own unique condition. Thank you for inviting me to be here with you today. I'd be happy to answer any questions or discuss these cases in more detail.